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Brazil: Precarious Economic Situation

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An Intelligence Assessment

State Dept. review
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Key Judgments

*Information available
as of 18 October 1982
was used in this report.*

Brazil's sudden difficulty in obtaining foreign loans beginning in September is causing growing concern among key officials about a foreign exchange crisis. Tightening international credit standards for less developed countries (LDCs) have put a sharp brake on Brazil's access to funds. Bankers have also been disconcerted by Brazil's worsening economic performance in 1982.

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Partly to offset this perception, Brasilia has, over the past few weeks, introduced a series of restrictive policies to shore up the economy and convince bankers to resume lending. Major banks recognize the stakes and are responding with some financial support. This quick reaction has temporarily stayed—but not disposed of—serious financial problems. We estimate that Brazilian borrowers needed to obtain some \$4 billion in new credits to avert foreign exchange difficulties in the fourth quarter.

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Brazil's foreign exchange position will remain precarious through the end of the year. It cannot withstand a prolonged slowdown in new lending because of large import and debt servicing requirements. The small size of the reserve cushion and continued difficulty in obtaining short-term credits will limit the government's ability to cope with new external shocks. Under these conditions, any miscalculations—by the lenders or the Brazilians—could soon trigger a cash-flow squeeze that would force Brazil into debt re-scheduling. We believe this is not inevitable, but the dangers are real.

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Even if a cash-flow squeeze is avoided, Brazil faces the need for major retrenchments in 1983 to improve economic performance and to retain banker support. The government recognizes the need for corrective economic policies and has already signaled intentions to make adjustments. At the moment, the Brazilian leadership is prepared to work quickly, quietly, and efficiently with creditors to resolve these problems.

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Economic retrenchment, however, will face challenges in Brazil, and the possibility remains that any self-initiated stabilization program will be implemented poorly. Consequently, Brazil will remain vulnerable to a loss in banker confidence, which, in turn, could quickly result in renewed foreign exchange difficulties any time through 1983.

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Debt servicing will constitute the greatest near-term threat to US commercial interests. These immediate financial problems, however, may obscure the potential for increasingly acrimonious bilateral commercial disputes. Brazil is likely to become more aggressive in promoting exports and to tighten import restrictions during the early stages of its adjustment program.

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**Brazil: Precarious
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Economic Backdrop

Brazilian Planning Minister Delfim Netto implemented economic austerity policies in late 1980 to avert a crisis in relations with foreign bankers. Delfim's measures slowed the economy, thereby improving the payments accounts, reducing triple-digit inflation, and restoring Brazil's tarnished international creditworthiness.

At the beginning of this year, however, fiscal and monetary policies were relaxed to spur recovery and absorb the unemployed with an eye to enhancing the government's electoral prospects. Trying to balance this, Delfim has recently implemented scattered policy adjustments such as selective investment cutbacks and tougher import restraints. Beyond this, he has—with mixed results—jawboned producers to hold the line on retail price increases to avert a severe burst of new inflation. Consequently, the Brazilian economy has been pulled in opposing directions by conflicting economic priorities. Monetary policy, for example, continues to provide subsidized credit to priority sectors but has resulted in high free market interest rates for private borrowers. The stimulative effects of increased government spending are being partially offset by new taxes and rising prices

Vacillating economic policies have resulted in domestic economic setbacks this year. The US Embassy indicates that economic recovery has been anemic. Upturn in the industrial sector—the key engine of growth—has been slow to get started because of high domestic interest rates, sluggish domestic demand, and a falloff in manufactured exports. Bad weather has caused agricultural output to decline. Despite gains in the extractive industries and new construction, we now anticipate real growth of less than 2 percent in 1982.

Inflation has headed higher. With the 8-percent increase in prices in June, Brazilian inflation rose to 97 percent on a 12-month basis, ending 14 months of improvements. We believe the inability to reduce the

government deficit, rapid monetary expansion, and continued rapid indexation adjustments will cause Brazilian inflation to run about 100 percent this year.

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Brasilia also faces renewed deterioration in the external accounts for 1982. Based on openly available trade and payments data for the first nine months of the year, we believe that the current account deficit will be close to \$14 billion, up 18 percent compared with last year. Despite a decline in imports, Brazil will manage only an estimated \$800 million trade surplus. We believe exports will decline some 10 percent to \$21 billion because of falling commodity prices, a sharp decline in sales to key Third World markets, and an erosion of price competitiveness because of the overvaluation of the cruzeiro. Rising interest payments on the foreign debt, increased dividend remittances, and large tourism expenditures should cause the service deficit to increase 13 percent to \$14.8 billion.

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Bankers' Attitudes

In light of these developments, international bankers are taking a closer look at Brazil's economic prospects. They are especially concerned about the growing current account deficit because it jeopardizes Brazil's ability to service its \$80 billion foreign debt. Moreover, stagflation—no growth with high inflation—is shaking confidence in Brazil's long-run development potential.

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These anxieties have led to Brazil's sudden problems in obtaining foreign loans. After smoothly arranging three-fourths of the financing necessary to cover the balance-of-payments gap, senior Brazilian officials have acknowledged publicly that foreign credit slowed abruptly in September. Brasilia claims to have obtained between \$700 million and \$1 billion in new loans last month. Although the actual amount is unknown, these inflows were apparently enough to avoid, temporarily, a cash shortage.

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Table 1
Brazil: Balance of Payments

Billion US \$

	1980	1981	1982 ^a	1983 ^b
Trade balance	-2.9	1.2	0.8	4.0
Exports (f.o.b.)	20.1	23.3	20.9	23.5
Imports (f.o.b.)	23.0	22.1	20.1	19.5
Service balance	-10.2	-13.1	-14.8	-13.5
Net interest	-6.3	-9.2	-10.7	-10.5
Other services	-3.9	-3.9	-4.1	-3.0
Transfers	0.2	0.2	0.2	0.2
Current account balance	-12.9	-11.7	-13.8	-9.3
Amortization ^c	6.7	7.7	7.1	7.0
Foreign capital requirements	19.6	19.4	20.9	16.3
Financed by:				
Foreign investment, net	1.5	2.3	2.0	2.3
Loan inflows	13.3	17.1	16.9	12.5
Long-term	10.6	15.6	15.4	10.0
Short-term	2.7	1.5	1.5	2.5
Reserve drawdowns	3.5	-0.6	1.0	0
Other capital ^d	1.6	1.2	1.0	1.5
Errors and omissions	-0.3	-0.6	0	0

^a Estimated.^b Projected.^c Medium- and long-term loans.^d Other capital mainly consists of repayments of Brazilian foreign loans.

Major US banks provided the bulk of the new credit. According to the US Embassy, however, Japanese, European, and US regional banks virtually ceased lending to Brazil last month.

Table 2
Brazil: Foreign Debt and Servicing Burden

	1980	1981	1982 ^a
<i>Billion US \$</i>			
Total debt	66.2	75	85
Medium- and long-term	53.8	60	68
Short-term	12.4	15	17
International reserves ^b	5.8	6.6	5.6
Net debt ^c	60.4	68.4	79.4
Debt service	13.0	16.9	17.8
Net interest	6.3	9.2	10.7
Amortization ^d	6.7	7.7	7.1
Exports	23.2	26.9	25.0
Goods	20.1	23.3	20.9
Commercial services	3.1	3.6	4.0
Imports	23.0	22.1	20.1
Gross domestic product ^e	248	283	292
<i>Percent</i>			
Short-term debt, as a share of total debt	18.7	20.0	20
Total debt, as a share of GDP	26.7	26.5	29
Debt service, as a share of exports	56.0	62.8	71
Debt service and imports, as a share of exports	155.2	145.0	152
Debt service, as a share of reserves	224.1	256.1	318
Debt service and imports, as a share of reserves	620.7	590.9	677
Debt service, as a share of GDP	5.2	6.0	6
Interest, as a share of exports	27.2	34.2	43

^a Estimated.^b Total reserves minus gold.^c Total debt minus reserves.^d Medium- and long-term.^e Gross domestic product in cruzeiros divided by average annual exchange rate.

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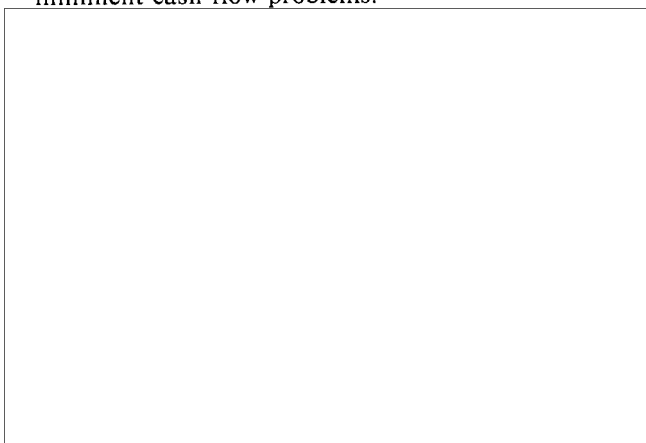
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Coping With Immediate Difficulties

Limited Room for Maneuver. Brasilia would have few ways to cope with a standdown in foreign lending that extended through the end of 1982. This year's debt servicing (some \$18 billion) and import requirements have exceeded merchandise export earnings by \$1.4 billion per month; an additional \$1-1.5 billion in short-term loans must be rolled over monthly. If large-scale lending is not restarted soon, Brasilia faces imminent cash-flow problems:



The Central Bank continues to syndicate a few high-quality loans, hoping successful placements will reassure the market. Additionally, Delfim and Central Bank President Langoni have recently met with US bankers to restate their intention to meet debt servicing obligations.



Major Financial Uncertainties. Brasilia's ability to raise the \$4 billion necessary to close the balance-of-payments gap this quarter remains uncertain. Major banks recognize the need to support Brazil to avoid financial panic. Their heavy loan exposure—the nine largest US banks have lent to Brazil an amount equal to 41 percent of their capital—limits their ability to extend long-term, large-scale support. Brasilia will also encounter difficulty in convincing smaller banks to resume lending. Additionally, these institutions still have the potential to trigger a financing crisis by demanding repayment of maturing short-term loans and denying Brazilian borrowers access to established credit lines.

The Choices. Before or after the elections, Brasilia may have to attempt to forestall a payments crisis by tightening exchange controls and import restraints or running up commercial arrears to conserve cash.

Tightened commercial restraints are unlikely to provide major foreign exchange savings without disrupting economic growth or exacerbating inflationary pressure. In these circumstances, pressure from Brazil's creditors would grow for Brasilia to submit to the discipline of an IMF agreement. We believe this course of action is likely. An IMF package would help to shore up banker confidence, thereby enabling Brasilia to reopen access to commercial credit sources. A Fund program also could permit Brasilia to reschedule its government-to-government debt under IMF auspices.

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Brazil's current political leaders are unlikely to declare a moratorium on debt repayments. Indeed, Brazilian officials have consistently and quickly repudiated a private-sector call for a suspension of debt repayments. Government leaders recognize that any unilateral interruption of debt service could irreparably harm Brazil's international creditworthiness and reduce access to Western capital necessary to sustain the march to *grandeza*; that is, major power status.

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Economic Reckoning in 1983

Even if a foreign exchange crisis is avoided, Brasilia will have to undertake major economic retrenchments in 1983. Reduced availability of foreign financing will require such changes.

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We believe numerous technical reforms will also be necessary for improved economic performance. To improve monetary management, the government needs to:

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- Consolidate the federal, state enterprise, and monetary budgets.
- Begin dismantling the extensive subsidy system.
- Cut into entitlement programs.
- Bring state corporations under better control.

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Financial reforms are necessary to improve the allocation of credit, especially for the private sector. Investment priorities need to be re-examined and the rate of new project spending brought into line with the availability of domestic savings. Brazil's famed indexation system will have to be modified to avoid perpetuating past inflation. Foreign exchange policies—the overvalued cruzeiro, multiple exchange rates, import barriers—will need to be rationalized to strengthen the external accounts and to improve the efficiency of market allocations. []

Making the Adjustments

The Strengths. Brazil has important inherent strengths in confronting this challenge. The national leadership is competent and in basic agreement on the economic policies necessary to resolve the current difficulties. They are flexible and pragmatic in the search for solutions. As a result, Brazilians have consistently found *jeitos*; that is, ways to maneuver out of seemingly impossible situations. []

Beyond this, the economy has important mechanisms for coping with economic strains. A large underground economy works to alleviate some of the stresses resulting from urban unemployment. Moreover, Brazilians can count on assistance from their extended families to blunt income losses. Reverse migration from city to countryside also provides unskilled workers with alternative, agricultural employment. []

The Dangers. Any major retrenchment program will be tested in an increasingly open political climate. Strong vested interests—agricultural producers, state corporations, private executives—will probably seek to blunt tough policies to preserve their real incomes. After two years of no growth, Brazilian leaders are probably concerned about the potential for social unrest. Despite Delfim's authority to mandate reforms, congressional committees could cause him to delay the adjustments. Any wavering in implementing corrective policies would undermine the efficacy of the adjustment program and banker willingness to continue necessary financial support. []

With a dwindling reserve cushion, Brasilia would face extreme foreign exchange difficulties if oil prices rose, world interest rates rebounded, commodity prices failed to recover, or climatic disasters resulted in new

export shortfalls. Over the next 12 months, however, we remain more concerned about the potential internal developments that could cause bankers to curtail their financial support:

- Tight monetary policies, the falloff in demand, and continued rapid indexation adjustments are straining business repayment capabilities. This could force private companies to seek external rescheduling and domestic debt relief.

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- Any approach to the IMF would be likely to draw heavy fire from Brazilian nationalists, thereby heightening the internal debate over unilateral debt rescheduling.

- Abrupt shifts in the Cabinet cannot be ruled out. Should they occur, they could lay the foundation for major economic policy changes. []

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Most Likely Course. Financial uncertainties between now and the end of the year make it difficult to predict Brazil's precise track for 1983. We judge, however, that the government will make every effort to solve its economic problems in cooperation with its foreign creditors and will seek IMF support. []

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The first signs of preparation for economic retrenchment are already evident. In recent weeks, Brasilia has increased reserve requirements, announced real cuts in public investments for 1983, accelerated the pace of minidevaluations, and tightened restraints on imports. According to the Embassy, the government will take tougher steps after the elections; the wage law will be modified, cuts will be made in subsidy programs, and taxes will likely be increased. []

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These moves, together with bankers' caution and the likely state of the international economy, point to a poor year for Brazil's economy. Our best estimate is that real growth will contract by as much as 5 percent next year, causing inflation to slow to 85 percent. Some recovery in exports, tight import restraints, and lower world interest rates will cause the Brazilian current account deficit to fall by more than 30 percent to the \$9 billion level, an amount that, with luck, could be financed. []

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US-Brazil: Some Economic Sticking Points

Increased trade is a crucial factor in Brazil's economic adjustment strategy for the 1980s. To meet growing import and debt servicing requirements, Brazil must sustain rapid growth in exports for large trade surpluses. The US market is crucially important. Sales to the United States—Brazil's largest market—increased 17 percent to \$4.1 billion last year. The United States absorbs an array of Brazilian products, ranging from coffee and iron ore to telecommunications apparatus.

In Brasilia's view, trade relations with the United States are difficult. The Brazilian Government and media have publicly expressed growing apprehension over US import restrictions:

- *Sugar: Quotas favoring sugar imports from the Caribbean bite into a major Brazilian income source.*
- *Orange juice: Florida Citrus Mutual wants to impose a duty on Brazilian orange juice concentrate.*
- *Steel: Five cases are pending against Brazilian steel products. Two others have been concluded in Brazil's favor.*
- *Aircraft: Texas's Fairchild-Swearingen has asked for a compensatory tax on commuter line aircraft sold in the United States by Brazil's Embraer.*

Brazilians also publicly view new US trade and financing initiatives as jeopardizing their ability to resolve their external payments problems. Brasilia perceives an economic threat from US efforts to extend General Agreement on Tariffs and Trade (GATT) regulations to exports of services, an increasingly important source of Brazilian export earnings. Washington also advocates the reduction of World

Bank economic assistance to emerging industrialized nations such as Brazil and their removal from the General System of Preferences. Brasilia protests that graduation is something it neither merits nor can afford.

Brazilians, however, have a number of questionable trading practices. Brazilian export subsidies, such as the overrebate of excise tax credits, are in violation of GATT regulations. Moreover, Brasilia has waffled on its commitment to phase out these subsidies. Although Brasilia eliminated export subsidies in December 1979, they were reinstituted in April 1981.

Brazil's export subsidies hurt US exporters in third-country markets. Subsidies on frozen chickens shipped to the Middle East have enabled Brazil to capture a major share of the market. For the future, the special export benefits granted under the Brazilian BEFIEX program are likely to adversely affect US trade interests. Under this program, participating companies are already committed to some \$60 billion in exports from Brazil during the next decade. In return, Brasilia will allow these companies to import tax-free the needed equipment and will grant a rebate on excise taxes levied on exports.

Brazilian import restrictions also adversely affect US exports, which declined some 15 percent to \$3.5 billion last year. Brazil's large domestic market is protected by high tariffs, temporary import taxes, and quotas. Beyond this, Brasilia's reservation of specific domestic markets for local manufacturers of such products as computers and small aircraft has drawn fire from US manufacturers.

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Social Implications. Economic pressures are likely to heighten manifestations of social unrest next year. Economic deprivation following any retrenchment could trigger increased violent crime, some wildcat strikes, cost-of-living demonstrations, and sporadic destruction of public property. Since 1979, these types of social protests have become more frequent in Brazil's more open political climate. [REDACTED]

At this juncture, however, a major social upheaval is unlikely. The Brazilian tradition of compromise, the lack of class consciousness among the poor, and the absence of a charismatic leader to unify the radical opposition militate against serious unrest over the near term. Of more immediate importance, Brasilia is likely to blunt popular frustrations by emphasizing that all social classes will be required to make sacrifices in 1983 to lay the foundations for future economic improvements. Beyond this, the Figueiredo government still retains important defenses—military support, tough national security laws—to prevent popular disturbances from getting out of hand. [REDACTED]

Relations With the United States

Debt servicing obviously constitutes the greatest near-term threat to bilateral relations. Although we believe Brasilia would move to arrange an orderly debt rescheduling, several of the largest US financial institutions—Citicorp, Chase Manhattan, Morgan Guaranty—could suffer serious profit declines if Brazil fails to make full interest payments. Beyond this, major Brazilian banks with large US subsidiaries could experience difficulty in arranging funds in the interbank market. [REDACTED]

These immediate financial problems may obscure the potential for increasingly acrimonious *commercial disputes*. Brasilia is already widely recognized as one of the world's most aggressive exporters and its need to improve the external payments position will probably make it even more active in external marketing. Additionally, high Brazilian tariffs and temporary import taxes are likely to be retained during the early stages of an adjustment program. Tighter import restrictions and exchange controls erected by Brazil to conserve foreign exchange would also disrupt bilateral trade ties and affect the profitability of US multinational corporations with large subsidiaries in Brazil.

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